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C O N F I D E N T I A L SECTION 01 OF 03 KYIV 001835

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TAGS: [EFIN](#) [EREL](#) [ETRD](#) [PGOV](#) [PINR](#) [UP](#) [XH](#)

SUBJECT: KYIV POPULISM COULD TRIGGER "FISCAL DEVASTATION"

Classified By: Economic Counselor Edward Kaska for Reasons 1.4 (b) and (d)

¶1. (SBU) Summary. Ukraine's shaky IMF program took another direct hit, after the Rada (parliament) enacted legislation to significantly increase budget spending for pensions and public sector wages. The IMF said the measure would lead to "fiscal devastation," while the World Bank estimated an increased government deficit of "at least a couple" percentage points of GDP. Tymoshenko, whose BYuT faction unanimously voted against the law, dubbed the move an "atomic bomb" for Ukraine's budget. Deputies from the Viktor Yanukovych-led Party of Regions provided overwhelming support for the law, together with members from OU-PSD, the Communist Party, and the Lytvyn Bloc. All eyes are now turned to President Viktor Yushchenko, whose advisors have given mixed signals about whether the President intends to veto the law. End summary.

#### DETAILS OF THE LAW

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¶2. (U) The Rada passed legislation on October 20 to increase public sector wages and pensions. The law provides for an initial rise in the monthly minimum wage from UAH 669 (\$83) to UAH 744 (\$93) on November 1, 2009, with subsequent quarterly augmentations in 2010. The increases would continue until the minimum wage reached UAH 922 (\$115), a 38% total rise. According to the law, pensions would increase 47% by the end of 2010. The current minimum monthly pension is UAH 498 (\$62), which would rise in pace with minimum wage increases until reaching UAH 734 (\$92). The social spending law was unanimously supported by the Party of Regions (172), Communist party (27), Lytvyn bloc (19), and the pro-presidential half of Our Ukraine-PSD (33).

#### IFI REACTION

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¶3. (SBU) IMF budget expert Igor Shpak told Econoff on October 21 that the law, if signed, would lead to "fiscal devastation." Nonetheless, the Kyiv-based official said that the IMF had concerns President Yushchenko would succumb to pressure and sign the law. IMF staff and mission team members were "hoping" Yushchenko's training as an economist would outweigh short-term political considerations. Shpak acknowledged that IMF envoy Ceyla Pazarbasioglu, currently in Kyiv to assess Ukraine's \$16.4 billion Stand-By Arrangement, had been actively engaged on the issue with the Presidential Secretariat.

¶4. (SBU) World Bank senior economist Ruslan Piontkivsky similarly commented that the law's potential impact was "at least a couple" of percentage points of GDP for 2010. He

expressed concern that such additional budget allocations would make the 2010 deficit too large to be financed by non-inflationary means, and he hoped that Yushchenko would veto the law.

#### BYUT OPPOSITION

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¶5. (U) Prime Minister Tymoshenko's bloc (BYuT) and the pro-coalition wing of OU-PSD refused to vote for what the PM called an "atomic bomb" for the state budget. BYuT representatives publicly called on President Yushchenko to veto the legislation.

¶6. (SBU) Deputy Prime Minister Turchynov stated the measure would cost UAH 8 billion (nearly \$1 billion) in 2009 alone and could lead to substantial hryvnia emission and inflation. Turchynov also noted that the measure had the potential to "ruin" Ukraine's financial system. Deputy Finance Minister Voldymyr Matviychuk said that the measure would require UAH 8 billion in additional funding in 2009 and UAH 71 billion (roughly \$8.6 billion) in 2010. In order to find the money to implement the law, Matviychuk speculated that the government would need to lay off 45% of public sector employees (teachers, doctors), an amount equal to 1.6 million jobs.

¶7. (SBU) BYuT MPs had told us on October 6 that they had allowed the measure to go forward beyond a first reading in exchange for Regions' guarantees to unblock the Rada's rostrum. BYuT's legislative agenda, particularly related to the 2010 budget law, had been stymied for weeks by Regions'

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demands for social spending increases.

#### PROPONENTS MORE SANGUINE

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¶8. (SBU) Contrary to dire projections by the Cabinet and Ministry of Finance, Party of Regions' shadow Finance Minister Azarov downplayed the law's fiscal effect, saying the measure would cost UAH 5.5 billion (UAH 2 billion to raise minimum wages and 3.5 billion to raise pensions). The author of the law, Lytvyn Bloc's Oleh Zarubinskiy, said that the increase could be funded with cuts to Presidential Secretariat and Cabinet of Ministers expenditures (by UAH 1 million and 17%, respectively).

#### PRESIDENT UNDECIDED

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¶9. (SBU) The President will likely receive pressure from a variety of sources. His own faction members from OU-PSD voted in favor of the pre-election spending increases. On the other hand, the President will have to contend with the IMF's concerns about the fiscal impact of the law.

¶10. (C) Deputy Head of the Presidential Secretariat Igor Popov told Poloff that the Secretariat had held an October 21 meeting on the law and was "split 50/50." Popov, who also serves as the President's representative to the Rada, said that Yushchenko had not determined whether to veto the law. While the President understood the law's "horrible" financial implications for the budget, Popov implied that the politics of the presidential campaign could drive Yushchenko's decision making. Throwing his hands up in the air, Popov declared "that's populism for you." The Presidential aide said Yushchenko had determined he would remain "silent" in the coming days before making a final decision.

¶11. (C) Roman Zhukovskiy, a senior economic advisor in the Presidential Secretariat, publicly indicated on October 20 that the Secretariat would propose to veto the bill. Zhukovskiy noted to us on October 21, however, that the President was "awaiting a more detailed study" of the law.

He acknowledged that the measure could be considered a "major threat to state finances," but that it was not the only one of the sort the President had contended with. Zhukovskiy admitted that he was personally opposed to the law and that he would continue to lobby against a Presidential signature.

¶12. (SBU) If Yushchenko were to veto the law, it is unclear whether Regions and the other groups in support of the law could muster support to override. Deputy Speaker Oleksandr Lavrynovych (Party of Regions) purported he had located enough Rada MPs to push through an override. Yet, Rada watchers have noted that Regions and its allies would have to whip up roughly 50 additional votes, a tough task that would require significant horse trading.

¶13. (U) The President also could rely on technical means to thwart final adoption of the law. Rada procedures require a bill's drafter to determine sources of financing and estimate the budget impact of a potential law. No such determinations were provided with the draft law on social spending. Furthermore, the Rada's legal committee has noted that current Ukrainian legislation requires the minimum wage and pension rate be set in conjunction with the current budget law, an action that had not been completed prior to passage.

COMMENT

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¶14. (SBU) It is difficult to fully assess the fiscal impact of the law, since it remains uncertain whether higher pension earners would be re-indexed according to the pension minimum.

The World Bank's Piontkivsky's estimation of roughly 2% of GDP expenditure increases did not account for re-indexed pensions at all levels. Perhaps a better indicator for the law's potential effect would be the Ministry of Finance's projections of general re-indexed pension rate adjustments, which would add roughly UAH 71 billion (nearly 7% of GDP) in budget obligations.

¶15. (C) Given the law's expected popularity among key voting constituents and the difficulty Tymoshenko's government would have in fulfilling its terms, Yushchenko may decide to let it pass. In this case, Tymoshenko would need to come up with extra cash for pensioners by November 1, putting at greater

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risk the government's ability to pay for other obligations. Regions appears to be betting that the President and Tymoshenko will suffer politically in any case.  
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